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UNDERSTANDING THE BASIC PRINCIPLES OF ACCOUNTING:
A CASE-BY-CASE APPLICATION

by
Katherine Collins Murphy

A thesis submitted to the faculty of The University of Mississippi in partial fulfillment of the requirements of the Sally McDonnell Barksdale Honors College.

Oxford
May 2018

Approved by

Advisor: Dr. Victoria Dickinson

Reader: Dr. W. Mark Wilder

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ABSTRACT

KATHERINE COLLINS MURPHY: Understanding the Basic Principles of Accounting: A Case-by-Case Application

(Under the direction of Dr. Victoria Dickinson)

This paper presents a range of solutions to twelve separate case studies that explore the basic principles of accounting. Each case study introduces a key topic of financial reporting that relates to a specific company or industry. The solutions were created in response to problem sets in each case that guided the analysis of the topic at hand. These problems required a basic understanding of accounting concepts and U.S. GAAP. The cases are independent of each other and require an assortment of skills including the preparation of journal entries, T-charts, and financial statements, along with a general comprehension of accounting concepts, financial analysis, and various calculations.

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LIST OF ABBREVIATIONS

ACCY	accountancy
A/P	accounts payable
APIC	additional paid in capital
ASC	Accounting Standards Codification
COGS	cost of goods sold
DTA	deferred tax asset
DTL	deferred tax liability
EPS	earnings per share
FASB	Financial Accounting Standards Board
FG	finished goods
GAAP	Generally Accepted Accounting Principles
PV	present value
R&D	research and development
RM	raw materials
RSU	restricted stock units
SG&A	selling, general, and administrative
WIP	work in process

CASE 1:

FINANCIAL ANALYSIS

Comparison Glenwood Heating, Inc. and Eads Heaters, Inc.

CASE 1: TABLE OF CONTENTS

EVALUATION OF GLENWOOD HEATING, INC.

Based on Glenwood's financial statements, their net income shows to be $92,742 with the majority of the company's expenses falling under "Other operating expenses." Glenwood's total stockholder's equity amounts to $229,542. This somewhat high number is due to the company's retained earnings of $69,542. Glenwood has a total liabilities balance of $413,090, which accounts for more than half of the company's total liabilities and stockholder's equity. According to the Statement of Cash Flows, they do not have much cash left on hand at the end of the year 20X1 (only $426). The company has a negative cash flow from operating activities amounting to $16,374. A negative cash flow can sometimes signify that a company is losing money. However, these statements are based on the first year of operation for Glenwood, so the negative balance could simply mean that the company's operating expenses have not yet been turned into cash profits.

EVALUATION OF EADS HEATERS, INC.

According to Eads' income statement, their net income amounts to $70,515 with the majority of the company's expenses belonging to "Depreciation expense." Eads has a total stockholder's equity of $207,315 with a retained earnings amount of $47,315. The company has a large amount of liabilities totaling $496,450. This number accounts for more than half of Eads' total liabilities and stockholder's equity. Looking at Eads' Statement of Cash Flows, they have an ending cash balance of $7,835. The company has a very small negative cash flow from operating activities amounting to $325. Although this balance is negative, it is a small amount, which could signify the company is growing and/or some of their operating expenses have not been made into a cash profit yet.

FINANCIAL ANALYSIS: WHICH COMPANY IS BETTER?

Glenwood Heating, Inc. and Eads Heaters, Inc. were both founded at the beginning of the year 20X1. Based on their financial statements after the first year of operation, one should be able to make a clear decision as to which company would be better to invest in. Many factors should be considered when deciding between companies to potentially invest in or lend money to. Which company has a better income? Who does a better job at turning expenses into profit? Between the two companies, which has a higher amount of retained earnings? By analyzing these questions and more, I have compared the financial statements of both heating companies and have come to the conclusion that Glenwood Heating, Inc. is the better company to invest in.

While one cannot base his or her decision solely on a company's net income, it is definitely a good place to start. Glenwood's net income at the end of year 20X1 is $92,742 while Eads' net income is $70,515. With over a $20,000 difference, Glenwood seems to be more promising based off of their ending income. The majority of Glenwood's expenses for the year went to "Other operating expenses" while most of Eads' fell under "Depreciation expense."

Next, I compared the two companies' Statements of Retained Earnings and their total stockholder's equity. Glenwood has ending retained earnings of $69,542 with a total stockholder's equity balance of $229,542. Eads has ending retained earnings of $47,315 and a total stockholder's equity balance of $207,315. A company's retained earnings refer to the net earnings of the year that are retained by the company to potentially be reinvested into the company or used to pay debt. Therefore, it is often preferable to invest in a company with higher retained earnings. With over $20,000 more in ending retained earnings, Glenwood appears to be the better choice.

While both companies have rather high total liability balances, Glenwood's balance is slightly lower at $413,090 compared to Eads' balance of $496,450. Glenwood would again be the better option based on a comparison of total liabilities as they have $83,360 less than Eads to pay in the upcoming years.

The last major financial statement that I observed was the Statement of Cash Flows for each company. Glenwood has a negative cash flow from operating activities amounting to $16,374 and an overall net cash balance of only $426. In comparison, Eads has a negative cash flow from operating activities of only $325 along with an overall net cash balance of $7,835. Based on this comparison of cash flows, Eads looks to be the better choice in company. These numbers suggest that Eads did a better job of converting their operating expenses into cash profit than Glenwood.

From the overall comparison of Glenwood Heating and Eads Heaters, Glenwood comes out on top when it comes to net income, retained earnings, and liabilities. Eads moves to the top with their cash flows for the year. All in all, Glenwood appears to be the better company to invest in, as they have multiple promising factors that lead me to believe they will continue to be successful in upcoming years.

In the following appendices, one can find all of the financial statements mentioned for both companies, along with their general ledgers and other supporting data.

APPENDIX A:

General Ledgers and Recorded Transactions

Glenwood Heating, Inc. and Eads Heaters, Inc.

The same 12 transactions were used for both Glenwood Heating, Inc. and Eads Heaters, Inc. Therefore, the two companies will have the same General Ledgers and Unadjusted Trial Balances, as shown here:

Home Heaters General Ledger-Part A				
Date	**Account**		**Debit**	**Credit**
1/02/10X1	Cash		$160,000	
		Common Stock		$160,000
1/02/20X1	Cash		400,000	
		Notes Payable		400,000
1/03/20X1	Land		70,000	
	Building		350,000	
		Cash		420,000
1/05/20X1	Equipment		80,000	
		Cash		80,000
12/31/20X1	Inventory		239,800	
		A/P		239,800
12/31/20X1	A/R		398,500	
		Sales		398,500
12/31/20X1	Cash		299,100	
		A/R		299,100
12/31/20X1	A/P		213,360	
		Cash		213,360
9/30/20X1	Notes Payable		20,000	
	Interest Expense		21,000	
		Cash		41,000
12/31/20X1	Other Operating Expenses		34,200	
		Cash		34,200
12/01/20X1	Dividends		23,200	
		Cash		23,200
12/31/20X1	Interest Expense		6,650	
		Interest Payable		6,650
Totals			**$2,315,810**	**$2,315,810**

Home Heaters
Part A: Recording Basic Transactions

	Assets						Liabilities			Stockholder's Equity	
	Cash	**A/R**	**Inventory**	**Land**	**Building**	**Equipment**	**A/P**	**Interest Payable**	**Notes Payable**	**CS**	**RE**
No. 1	$160,000									($160,000)	
No. 2	400,000								($400,000)		
No. 3	(420,000)			$70,000	$350,000						
No. 4	(80,000)					$80,000					
No. 5			$239,800				($239,800)				
No. 6		$398,500									
No. 7	299,100	(299,100)									
No. 8	(213,360)						213,360				
No. 9	(41,000)								20,000		
No. 10	(34,200)										
No. 11	(23,200)										
No. 12								($6,650)			
Balances	**$47,340**	**$99,400**	**$239,800**	**$70,000**	**$350,000**	**$80,000**	**$26,440**	**$6,650**	**$380,000**	**$160,000**	**$313,450**

Home Heaters Unadjusted Trial Balance-Part A		
	Debits	**Credits**
Cash	$47,340	
Accounts Receivable	99,400	
Inventory	239,800	
Land	70,000	
Building	350,000	
Equipment	80,000	
Accounts Payable		$26,440
Notes Payable		380,000
Interest Payable		6,650
Common Stock		160,000
Dividends	23,200	
Sales		398,500
Other Operating Expenses	34,200	
Interest Expense	27,650	
Total	**$971,590**	**$971,590**

APPENDIX B:

Glenwood Heating, Inc.

Financial Statements and Data

Glenwood Heating, Inc. Part B: Adjusting Entries			
Date	**Account**	**Debit**	**Credit**
12/31/20X1	Bad Debt Exp.	$994	
	Allow. Bad Debts		$994
12/31/20X1	COGS	177,000	
	Inventory		177,000
12/31/20X1	Depreciation Exp.	10,000	
	Acc. Dep. - Building		10,000
12/31/20X1	Depreciation Exp.	9,000	
	Acc. Dep. - Equipment		9,000
12/31/20X1	Rent Expense	16,000	
	Cash		16,000
12/31/20X1	Provision Income Tax	30,914	
	Cash		30,914
Totals		**$243,908**	**$243,908**

Glenwood Heating, Inc. - Chart of Accounts
Part B: Recording Additional Information

	Assets									Liabilities			Stockholder's Equity	
	Cash	A/R	ADA	Inventory	Land	Building	Accum. Dep. Building	Equipment	Accum. Dep. Equipment	A/P	Interest Payable	N/P	CS	RE
Balances: Part A	$47,340	$99,400		$239,800	$70,000	$350,000		$80,000		$26,440	$6,650	$380,000	$160,000	$313,450
Part B (1) Bad Debts			($994)											
Part B (2) COGS				($177,000)										
Part B (3) Depreciation														
Building							($10,000)							
Equipment									($9,000)					
Part B (4) Equipment														
Rental Payment	($16,000)													
Part B (5) Income Tax	($30,914)													
Balances	**$426**	**$99,400**	**$994**	**$62,800**	**$70,000**	**$350,000**	**$10,000**	**$80,000**	**$9,000**	**$26,440**	**$6,650**	**$380,000**	**$160,000**	**$313,450**

Glenwood Heating, Inc. Adjusted Trial Balance As of December 31, 20X1		
	Debit	**Credit**
Cash	$426	
Accounts Receivable	99,400	
Allowance for Bad Debts		$994
Inventory	62,800	
Land	70,000	
Building	350,000	
Accumulated Depreciation, Building		10,000
Equipment	80,000	
Accumulated Depreciation, Equipment		9,000
Accounts Payable		26,440
Interest Payable		6,650
Notes Payable		380,000
Common Stock		160,000
Dividends	23,200	
Sales		398,500
Cost of Goods Sold	177,000	
Bad Debt Expense	994	
Depreciation Expense, Building	10,000	
Depreciation Expense, Equipment	9,000	
Interest Expense	27,650	
Other Operating Expenses	34,200	
Rent Expense	16,000	
Provision for Income Taxes	30,914	
Total	**$991,584**	**$991,584**

Glenwood Heating, Inc.
Balance Sheet
As of December 31, 20X1

Assets				**Liabilities and Stockholder's Equity**		
CURRENT ASSETS				**CURRENT LIABILITIES**		
Cash		$426		Accounts Payable	$26,440	
Accounts Receivable	$99,400			Notes Payable	380,000	
Less: Allowance for Bad Debts	(994)	98,406		Interest Payable	6,650	
Inventory		62,800		*Total Liabilities*		$413,090
Total Current Assets			$161,632			
PLANT, PROPERTY, EQUIPMENT				**STOCKHOLDER'S EQUITY**		
Land		70,000		Common Stock	160,000	
Building	350,000			Retained Earnings	69,542	
Equipment	80,000			*Total Stockholder's Equity*		229,542
Less: Accumulated Depreciation	(19,000)	411,000				
Total Property, Plant, and Equipment			481,000			
Total Assets			**$642,632**	**Total Liabilities and Stockholder's Equity**		**$642,632**

Glenwood Heating, Inc. Income Statement For Year Ended December 31, 20X1		
REVENUES		
Sales		$398,500
Less: Cost of Goods Sold		(177,000)
Gross Profit		221,500
EXPENSES		
Bad Debt Expense	$994	
Depreciation Expense	19,000	
Interest Expense	27,650	
Other Operating Expenses	34,200	
Rent Expense	16,000	
Provisions for Income Taxes	30,914	
Total Expenses		(128,758)
Net Income		**$92,742**

Glenwood Heating, Inc. Statement of Retained Earnings For Year Ended December 31, 20X1	
Retained Earnings - January 1, 20X1	$0
Net Income	92,742
	$92,742
Less: Dividends	(23,200)
Retained Earnings - December 31, 20X1	**$69,542**

Glenwood Heating, Inc. Statement of Cash Flows (Indirect Method) For the Year Ended December 31, 20X1		
CASH FLOWS FROM OPERATING ACTIVITIES		
Net Income		$92,742
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation Expense	$19,000	
Increase in Accounts Receivable (net)	(98,406)	
Increase in Accounts Payable	26,440	
Increase in Inventory	(62,800)	
Increase in Interest Payable	6,650	(109,116)
Net cash used by operating activities		(16,374)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of Land	(70,000)	
Purchase of Building	(350,000)	
Purchase of Equipment	(80,000)	
Net cash used by investing activities		(500,000)
CASH FLOWS FROM FINANCING ACTIVITIES		
Increase in Notes Payable	380,000	
Issuance of Common Stock	160,000	
Payment of Cash Dividends	(23,200)	
Net cash provided by financing activities		516,800
Net Increase in Cash		**$426**

APPENDIX C:

Eads Heaters, Inc.

Financial Statements and Data

Eads Heaters, Inc. Part B: Adjusting Entries			
Date	**Account**	**Debit**	**Credit**
12/31/20X1	Bad Debt Exp.	$4,970	
	Allow. Bad Debts		$4,970
12/31/20X1	COGS	188,800	
	Inventory		188,800
12/31/20X1	Depreciation Exp.	10,000	
	Acc. Dep. - Building		10,000
12/31/20X1	Depreciation Exp.	20,000	
	Acc. Dep. - Equipment		20,000
12/31/20X1	Leased Equipment	92,000	
	Lease Payable		92,000
12/31/20X1	Interest Expense	7,360	
	Lease Payable	8640	
	Cash		16,000
12/31/20X1	Depreciation Exp.	11,500	
	Acc. Dep. - Leased Equip.		11,500
12/31/20X1	Provision Income Tax	23,505	
	Cash		23,505
Totals		**$366,775**	**$366,775**

Eads Heaters, Inc. - Chart of Accounts
Part B: Recording Additional Data

	Assets										
	Cash	**A/R**	**ADA**	**Inventory**	**Land**	**Building**	**Accum. Dep. Building**	**Equipment**	**Accum. Dep. Equipment**	**Leased Equipment**	**Accum. Dep. Leased Equipment**
Balances: Part A	$47,340	$99,400		$239,800	$70,000	$350,000		$80,000			
Part B (1) Bad Debts			($4,970)								
Part B (2) COGS				($188,800)							
Part B (3) Depreciation											
Building							($10,000)				
Equipment									($20,000)		
Part B (4) Equipment											
Lease										$92,000	
Lease Payment	($16,000)										
Depreciation											($11,500)
Part B (5) Income Tax	($23,505)										
Balances	**$7,835**	**$99,400**	**$4,970**	**$51,000**	**$70,000**	**$350,000**	**$10,000**	**$80,000**	**$20,000**	**$92,000**	**$11,500**

Eads Heaters, Inc. - Chart of Accounts
Part B: Recording Additional Data (Continued)

	Liabilities				Stockholder's Equity	
	A/P	**Interest Payable**	**N/P**	**Lease Payable**	**CS**	**RE**
Balances: Part A	$26,440	$6,650	$380,000		$160,000	$313,450
Part B (1) Bad Debts						
Part B (2) COGS						
Part B (3) Depreciation						
Building						
Equipment						
Part B (4) Equipment						
Lease				($92,000)		
Lease Payment				$8,640		
Depreciation						
Part B (5) Income Tax						
Balances	**$26,440**	**$6,650**	**$380,000**	**$83,360**	**$160,000**	**$313,450**

Eads Heaters, Inc.
Adjusted Trial Balance
As of December 31, 20X1

	Debit	Credit
Cash	$7,835	
Accounts Receivable	99,400	
Allowance for Bad Debts		$4,970
Inventory	51,000	
Land	70,000	
Building	350,000	
Accumulated Depreciation, Building		10,000
Equipment	80,000	
Accumulated Depreciation, Equipment		20,000
Leased Equipment	92,000	
Accumulated Depreciation, Leased Equipment		11,500
Accounts Payable		26,440
Interest Payable		6,650
Notes Payable		380,000
Lease Payable		83,360
Common Stock		160,000
Dividends	23,200	
Sales		398,500
Cost of Goods Sold	188,800	
Bad Debt Expense	4,970	
Depreciation Expense, Building	10,000	
Depreciation Expense, Equipment	20,000	
Depreciation Expense, Leased Equipment	11,500	
Interest Expense	35,010	
Other Operating Expenses	34,200	
Provision for Income Taxes	23,505	
Total	**$1,101,420**	**$1,101,420**

Eads Heaters, Inc.
Balance Sheet
As of December 31, 20X1

Assets				**Liabilities and Stockholder's Equity**		
CURRENT ASSETS				**CURRENT LIABILITIES**		
Cash		$7,835		Accounts Payable	$26,440	
Accounts Receivable	$99,400			Notes Payable	380,000	
Less: Allowance for Bad Debts	(4,970)	94,430		Interest Payable	6,650	
Inventory		51,000		Lease Payable	83,360	
Total Current Assets			$153,265	*Total Liabilities*		$496,450
PLANT, PROPERTY, EQUIPMENT				**STOCKHOLDER'S EQUITY**		
Land		70,000		Common Stock	160,000	
Building		350,000		Retained Earnings	47,315	
Equipment		80,000		Total Stockholder's Equity		207,315
Leased Equipment		92,000				
Less: Accumulated Depreciation		(41,500)				
Total Property, Plant, and Equipment			550,500			
Total Assets			**$703,765**	**Total Liabilities and Stockholder's Equity**		**$703,765**

Eads Heaters, Inc. Income Statement For Year Ended December 31, 20X1		
REVENUES		
Sales		$398,500
Less: Cost of Goods Sold		(188,800)
Gross Profit		209,700
EXPENSES		
Bad Debt Expense	$4,970	
Depreciation Expense	41,500	
Interest Expense	35,010	
Other Operating Expenses	34,200	
Provisions for Income Taxes	23,505	
Total Expenses		(139,185)
Net Income		**$70,515**

Eads Heaters, Inc. Statement of Retained Earnings For Year Ended December 31, 20X1	
Retained Earnings - January 1, 20X1	$0
Net Income	70,515
	$70,515
Less: Dividends	(23,200)
Retained Earnings - December 31, 20X1	**$47,315**

Eads Heaters, Inc. Statement of Cash Flows (Indirect Method) For the Year Ended December 31, 20X1		
CASH FLOWS FROM OPERATING ACTIVITIES		
Net Income		$70,515
Adjustments to reconcile net income to		
net cash provided by operating activities:		
Depreciation Expense	$41,500	
Increase in Accounts Receivable (net)	(94,430)	
Increase in Accounts Payable	26,440	
Increase in Inventory	(51,000)	
Increase in Interest Payable	6,650	(70,840)
Net cash used by operating activities		(325)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of Land	(70,000)	
Purchase of Building	(350,000)	
Purchase of Equipment	(80,000)	
Capital Lease Payment	(8,640)	
Net cash used by investing activities		(508,640)
CASH FLOWS FROM FINANCING ACTIVITIES		
Increase in Notes Payable	380,000	
Issuance of Common Stock	160,000	
Payment of Cash Dividends	(23,200)	
Net cash provided by financing activities		516,800
Net Increase in Cash		**$7,835**

CASE 2:

IINCOME STATEMENT PRESENTATION

Totz and Doodlez

The following information is to be presented in a multistep income statement for the years 2015 and 2016 for Totz clothing store and Doodlez art studio:

1. The net sales for both Totz and Doodlez will be found in the sales and other operating revenue section of the income statement. With the company's cash flow coming from two different types of transactions, their total net sales can be split into separate categories. The income from selling clothing at Totz can be presented under "Net sales from tangible products" and it will amount to $70.6 million for 2015 and $75.3 million for 2016. The income from the art services provided by Doodlez can be presented under "Revenues from services" and will amount to $3.9 million for 2015 and $11.2 million for 2016. This gives the company total net sales of $74.5 million for fiscal year 2015 and $86.5 million for fiscal year 2016. The explanation for this separation can be found in ASC 225-10-S99-2.

2. The cost of sales for the company may also be split up into more detailed categories. We are told that the cost of sales includes product cost, import costs and direct labor costs, along with expenses incurred to produce inventory for sale. Therefore, the overall cost of sales could be split into: "Cost of tangible goods sold" which would account for the clothing sold by Totz, "Cost of services" which would account for the art services provided by Doodlez, "Product cost," and "Direct labor costs" for the work of the Doodlez employees. This break down of the costs of sales can be found in ASC 225-10-S99-2, point #2 and is also explained in ASC 255-10-55-17.

3. Totz recognized a gain of $1.7 million on the sale of an abandoned building after it relocated its headquarters. This gain should be reported under "Income from continuing operations before income taxes," as explained in ASC 360-10-45-5. This concept is further explained and broken down under ASC 360-10-45-9.

4. After a class action lawsuit against a supplier, Totz received proceeds of $2.7 million as settlement. While this is typically considered an unusual or infrequent transaction, it cannot be presented on the face of the income statement, as it may suggest there are extraordinary items. Instead, it should be disclosed in footnotes to the financial statement. This reasoning is presented under ASC 225-20-45-16. Alternatively, it could also be presented under “Non-operating income” under a miscellaneous category, as to not imply an extraordinary gain. This presentation alternative should also be acknowledged in the footnotes to explain its position on the income statement.

CASE 3:

FINANCIAL STATEMENT ANALYSIS AND PRESENTATION

Rocky Mountain Chocolate Factory

CASE 3: TABLE OF CONTENTS

		Beginning Balance (February 28, 2009)	1. Purchase Inventory	2. Incur Factory Wages	3. Sell Inventory for Cash and on Account	4. Pay for Inventory	5. Collect Receivables	6. Incur SG&A (cash and payable)	7. Pay Wages	8. Receive Franchise Fee	9. Purchase PP&E	10. Dividends Declared and Paid	11. All Other Transactions	Unadjusted Trial Balance
Dr.	Cash and Cash Equivalents	1,253,947			17,000,000	8,200,000	4,100,000	2,000,000	6,423,789	125,000	498,832	2,403,458	790,224	3,743,092
	Accounts Receivable	4,229,733			5,000,000		4,100,000						702,207	4,427,526
	Notes Receivable, Current	0											91,059	91,059
	Inventories	4,064,611	7,500,000	6,000,000	14,000,000								66,328	3,498,283
	Deferred Income Taxes	369,197											92,052	461,249
	Other Current Assets	224,378											4,215	220,163
	Property and Equipment, Net	5,253,598									498,832		132,859	5,885,289
	Notes Receivable, Less Current	124,452											139,198	263,650
	Goodwill, Net	1,046,944												1,046,944
	Intangible assets, Net	183,135											73,110	110,025
	Other Long Term Assets	91,057											3,007	88,050
Cr.	Accounts Payable	1,074,643	7,500,000			8,200,000							503,189	877,832
	Accrued Salaries and Wages	423,789		6,000,000					6,423,789					0
	Other Accrued Expenses	531,941						3,300,000					2,885,413	946,528
	Dividends Payable	598,986										3,709	1	602,694
	Deferred Income	142,000								125,000			46,062	220,938
	Deferred Income Taxes	827,700											66,729	894,429
	Common Stock	179,696											1,112	180,808
	Additional Paid-in-Capital	7,311,280											315,322	7,626,602
	Retained Earnings	5,751,017										2,407,167		3,343,850
	Sales	0			22,000,000								944,017	22,944,017
	Franchise and Royalty fees	0											5,492,531	5,492,531
Dr.	Cost of Sales	0			14,000,000								693,786	14,693,786
	Franchise Costs	0											1,499,477	1,499,477
	Sales and Marketing	0						1,505,431						1,505,431
	General and Administrative	0						2,044,569					261,622	1,782,947
	Retail Operating	0						1,750,000						1,750,000
	Depreciation and Amortization	0												0
	Interest Income	0											27,210	27,210
	Income Tax Expense	0											2,090,468	2,090,468

		Unadjusted Trial Balance	12. Adjust for Inventory Count	13. Record Depreciation	14. Wage Accrual	15. Consultant's Report	Pre-closing Trial Balance	16. Closing Entry	Post-closing Balance	Actual February 28, 2010 F/S Figures
Dr.	Cash and Cash Equivalents	3,743,092					3,743,092		3,743,092	3,743,092
	Accounts Receivable	4,427,526					4,427,526		4,427,526	4,427,526
	Notes Receivable, Current	91,059					91,059		91,059	91,059
	Inventories	3,498,283	216,836				3,281,447		3,281,447	3,281,447
	Deferred Income Taxes	461,249					461,249		461,249	461,249
	Other Current Assets	220,163					220,163		220,163	220,163
	Property and Equipment, Net	5,885,289		698,580			5,186,709		5,186,709	5,186,709
	Notes Receivable, Less Current	263,650					263,650		263,650	263,650
	Goodwill, Net	1,046,944					1,046,944		1,046,944	1,046,944
	Intangible assets, Net	110,025					110,025		110,025	110,025
	Other Long Term Assets	88,050					88,050		88,050	88,050
Cr.	Accounts Payable	877,832					877,832		877,832	877,832
	Accrued Salaries and Wages	0			646,156		646,156		646,156	646,156
	Other Accrued Expenses	946,528					946,528		946,528	946,528
	Dividends Payable	602,694					602,694		602,694	602,694
	Deferred Income	220,938					220,938		220,938	220,938
	Deferred Income Taxes	894,429					894,429		894,429	894,429
	Common Stock	180,808					180,808		180,808	180,808
	Additional Paid-in-Capital	7,626,602					7,626,602		7,626,602	7,626,602
	Retained Earnings	3,343,850					3,343,850	3,580,077	6,923,927	6,923,927
	Sales	22,944,017					22,944,017	22,944,017	0	22,944,017
	Franchise and Royalty fees	5,492,531					5,492,531	5,492,531	0	5,492,531
Dr.	Cost of Sales	14,693,786	216,836				14,910,622	14,910,622	0	14,910,622
	Franchise Costs	1,499,477					1,499,477	1,499,477	0	1,499,477
	Sales and Marketing	1,505,431					1,505,431	1,505,431	0	1,505,431
	General and Administrative	1,782,947			639,200		2,422,147	2,422,147	0	2,422,147
	Retail Operating	1,750,000			6,956		1,756,956	1,756,956	0	1,756,956
	Depreciation and Amortization	0		698,580			698,580	698,580	0	698,580
	Interest Income	27,210					27,210	27,210	0	27,210
	Income Tax Expense	2,090,468					2,090,468	2,090,468	0	2,090,468

Rocky Mountain Chocolate Factory, Inc.
General Ledger

		Debits	Credits
1	Inventory	7,500,000	
	Accounts Payable		7,500,000
2	Inventory	6,000,000	
	Accrued Salaries and Wages		6,000,000
3	Cash and Cash Equivalents	17,000,000	
	Accounts Receivable	5,000,000	
	Sales		22,000,000
	Cost of Goods Sold	14,000,000	
	Inventory		14,000,000
4	Accounts Payable	8,200,000	
	Cash and Cash Equivalents		8,200,000
5	Cash and Cash Equivalents	4,100,000	
	Accounts Receivable		4,100,000
6	Sales and Marketing Expenses	1,505,431	
	Gen. and Admin. Expenses	2,044,569	
	Retail Operating Expenses	1,750,000	
	Cash and Cash Equivalents		2,000,000
	Other Accrued Expenses		3,300,000
7	Accrued Salaries and Wages	6,423,789	
	Cash and Cash Equivalents		6,423,789
8	Cash and Cash Equivalents	125,000	
	Deferred Income		125,000
9	Property and Equipment, Net	498,832	
	Cash and Cash Equivalents		498,832
10	Retained Earnings	2,407,167	
	Cash and Cash Equivalents		2,403,458
	Dividends Payable		3,709
11	*transactions given on data sheet*		

Unadjusted Trial Balance Rocky Mountain Chocolate Factory, Inc. As of Februrary 28, 2010		
	Debits	**Credits**
Cash & Cash Equivalents	$3,743,092	
Accounts Receivable	4,427,526	
Notes Receivable, Current	91,059	
Inventories	3,498,283	
Deferred Income Taxes	461,249	
Other Current Assets	220,163	
Property & Equipment, Net	5,885,289	
Note Receivable, Less Current	263,650	
Goodwill, Net	1,046,944	
Intangible Assets, Net	110,025	
Other Long Term Assets	88,050	
Accounts Payable		$877,832
Accrued Salaries & Wages		0
Other Accrued Expenses		946,528
Dividends Payable		602,694
Deferred Income		220,938
Deferred Income Taxes		894,429
Common Stock		180,808
Additional Paid-in-Capital		7,626,602
Retained Earnings		3,343,850
Sales		22,944,017
Franchise & Royalty Fees		5,492,531
Cost of Sales	14,693,786	
Franchise Costs	1,499,477	
Sales & Marketing Expenses	1,505,431	
Gen. & Admin. Expenses	1,782,947	
Retail Operating Expenses	1,750,000	
Dep. & Amort. Expenses	0	
Interest Income Expenses		27,210
Income Tax Expense	2,090,468	
Totals:	**$43,157,439**	**$43,157,439**

Rocky Mountain Chocolate Factory, Inc. Adjusting Entries			
		Debits	**Credits**
12	Cost of Goods Sold	216,836	
	Inventory		216,836
13	Dep. and Amort. Expense	698,580	
	Property and Equipment, Net		698,580
14	Gen. and Admin. Expense	639,200	
	Retail Operating Expense	6,956	
	Accrued Salaries and Wages		646,156
15	*no entry*		

Adjusted Trial Balance Rocky Mountain Chocolate Factory, Inc. As of Februrary 28, 2010		
	Debits	**Credits**
Cash & Cash Equivalents	$3,743,092	
Accounts Receivable	4,427,526	
Notes Receivable, Current	91,059	
Inventories	3,281,447	
Deferred Income Taxes	461,249	
Other Current Assets	220,163	
Property & Equipment, Net	5,186,709	
Note Receivable, Less Current	263,650	
Goodwill, Net	1,046,944	
Intangible Assets, Net	110,025	
Other Long Term Assets	88,050	
Accounts Payable		$877,832
Accrued Salaries & Wages		646,156
Other Accrued Expenses		946,528
Dividends Payable		602,694
Deferred Income		220,938
Deferred Income Taxes		894,429
Common Stock		180,808
Additional Paid-in-Capital		7,626,602
Retained Earnings		3,343,850
Sales		22,944,017
Franchise & Royalty Fees		5,492,531
Cost of Sales	14,910,622	
Franchise Costs	1,499,477	
Sales & Marketing Expenses	1,505,431	
Gen. & Admin. Expenses	2,422,147	
Retail Operating Expenses	1,756,956	
Dep. & Amort. Expenses	698,580	
Interest Income Expenses		27,210
Income Tax Expense	2,090,468	
Totals:	**$43,803,595**	**$43,803,595**

Rocky Mountain Chocolate Factory, Inc. Closing Entries		
	Debits	**Credits**
Sales	22,944,017	
Franchise and Royalty Fees	5,492,531	
Income Summary		28,436,548
Income Summary	24,883,681	
Cost of Sales		14,910,622
Franchise Costs		1,499,477
Sales and Marketing		1,505,431
Gen. and Admin.		2,422,147
Retail Operating		1,756,956
Dep. and Amort.		698,580
Income Tax Expense		2,090,468
Income Summary	3,552,867	
Interest Income	27,210	
Retained Earnings		3,580,077

Rocky Mountain Chocolate Factory, Inc.			
Balance Sheet			
As of Februrary 28, 2010			
ASSETS		**LIABILITIES**	
Cash and Cash Equivalents	$3,743,092	Accounts Payable	$877,832
Accounts Receivable	4,427,526	Accrued Salaries and Wages	646,156
Notes Receivable, Current	91,059	Other Accrued Expenses	946,528
Inventories	3,281,447	Dividends Payable	602,694
Deferred Income Tax	461,249	Deferred Income	220,938
Other Current Assets	220,163	*Total Current Liabilities*	3,294,148
Total Current Assets	12,224,536		
		Deferred Income Taxes	894,429
		Total Liabilities	4,188,577
Property and Equipment, Net	5,186,709	**STOCKHOLDER'S EQUITY**	
Notes Receivable, Less Current	263,650	Common Stock	180,808
Goodwill, Net	1,046,944	Additional Paid-in-Capital	7,626,602
Intangible Assets, Net	110,025	Retained Earnings	6,923,927
Other Long Term Assets	88,050	*Total Stockholders' Equity*	14,731,337
Total Assets	**$18,919,914**	**Total Liabilities and Stockholders' Equity**	**$18,919,914**

Rocky Mountain Chocolate Factory, Inc. Income Statement For the Year Ended Februrary 28, 2010	
REVENUES	
Sales	$22,944,017
Franchise and Royaly Fees	5,492,531
Total Revenues	28,436,548
EXPENSES	
Cost of Sales	14,910,622
Franchise Costs	1,499,477
Sales and Marketing Expense	1,505,431
Gen. and Admin. Expense	2,422,147
Retail Operating Expense	1,756,956
Dep. and Amort. Expense	698,580
Total Operating Income	5,643,335
Interest Income Expense	27,210
Income Before Tax	5,670,545
Income Tax Expense	2,090,468
Net Income	**$3,580,077**

Rocky Mountain Chocolate Factory, Inc. Statement of Retained Earnings For the Year Ended Februrary 28, 2010	
Beginning Retained Earnings	$3,343,850
Net Income	3,580,077
Less: Dividends	0
Retained Earnings - February 28, 2010	**$6,923,927**

Transaction Number	Cash Flow Classification
1	Operating
2	Operating
3	Operating
4	Operating
5	Operating
6	Operating
7	Operating
8	Operating
9	Investing
10	Financing
11	Various (all other transactions)
12	Operating
13	Operating
14	Operating
15	(no transaction)

CASE 4:

INTERNAL CONTROLS

Potential Fraud Schemes

FRAUD SCHEMES

Potential Fraud Scheme	Internal Control
The store only has one credit card machine located in between the two cash registers.	Documentation - Transactions could get mixed up between the two cash registers: have a credit card machine for each cash register. Running two different purchases at the same time could allow for an employee to steal money: have proper documentation for theft prevention. If the credit card machine fails, there is no way to track transactions/ inflow or outflow of money: have an alternate system of documentation in addition to the credit card machine and two cash registers.
Every single employee has their own access code to both registers, increasing the risk of possible errors or discrepancies during transactions.	Access Controls - Limit the number of workers with access to the registers and/or assign employees to certain registers that they can use. Check the accounting software to identify any variances under specific users.

Employees can steal inventory.	Physical Audits - The store should perform a physical inventory count once a month (or after a certain period of time) and compare physical inventory with recorded inventory.
Employees could alter the amount of cash removed from the cash registers so that the amount of money on the receipts and the amount removed from the register do not match up.	Reconciliations - Reconcile the register tape with the store sales receipts. The amount of cash and credit sales should equal the amount of the register and store sales receipts. Also take a physical count of money totals in each cash register at the end of each day.
Lucy has the ability to incorrectly record the daily sales and take money from the register.	Separation of Duties - One employee should monitor Lucy while she records daily sales. Another employee should evaluate Lucy's documentation for any errors. Alternatively, one employee should record the sales and another employee should prepare the bank deposits.

Electronic cash registers could be hacked from an outside source. No employee has a key to the register, leaving it vulnerable to outside access.	Access Controls - More security is required for the cash registers. Additional passwords and theft protection software is needed. Lucy and Kayla should have keys to the registers for managerial duties. Each time one of them opens a register, another employee must be present to monitor their activity.
Lucy has the ability to steal from the store when dealing with small customer issues. She is able to falsify refunds for customers that do not exist.	Separation of Duties - One employee should deal with the customer issue while another employee issues the refund or new product.
Because the clerks have full authority to perform all types of transactions, they are able to create fake returns and steal money from the register.	Physical Audits - Performing regular physical inventory examinations would help prevent employees from stealing from the store. Only authorize certain employees to perform certain transactions.

Every single employee works on Saturday; each has the ability to collude with another employee on this day.	<u>Separation of Duties</u> - Each employee needs to rotate shifts and work with different employees every day of the week that he/she works.
Lucy has her own locked office. She could conceal fraudulent behavior more easily than the other employees. Her office is located in the back of the store away from other employees and customers.	<u>Access Controls</u> - Lucy should have video or other surveillance installed in her office. She should have windows that allow visible access into her office. Kayla should have a key to Lucy's office to monitor her actions.
Lucy prepares the bank deposits and records daily sales.	<u>Separation of Duties</u> - Kayla should examine and approve bank deposits and daily sales before they are completed in order to minimize fraud.
Advertising expenses could have been overstated and an employee could have pocketed the extra funds.	<u>Documentation</u> - Employees should be required to document every single transaction to the exact dollar amount that pertains to advertising and promotion. Kayla should check these transactions with the physical product.

Clerks are able to use coupons every time they purchase inventory from the store and can steal the difference from the register.	Authority Approval - Lucy or Kayla should be the only ones that can approve discounts and coupons with a unique code. If there is a large number of coupons, the coupons should be required to be scanned in before the sale and collected to show the customer the total that he/she owes.
As seen in the anonymous note left on her desk, Kayla leaves her office unlocked. Employees can steal money or inventory from her office.	Access Controls - Kayla should install office doors that automatically lock when they shut. This would prevent anonymous people from walking undetected into Kayla's office. Alternatively, Kayla should practice locking her door every time she leaves her office.

Employees are able to steal cash from the register during the day without Kayla knowing exactly which employee stole the cash.	Access Controls - Employees should be required to close out their cash box at the end of their shift at a particular register. This would show who is responsible if money goes missing. Employees should be required to only work on one register during his/ her shift, and each cash register should only be used by one employee each shift.

Additional Potential Fraud: If Kayla (the owner) is a potential suspect.

Kayla, acting as the owner of her store, also has the opportunity to steal from herself. Her ownership position would offer a good cover-up for committing fraud. She has her own office in the back of the store that only she has access to. She also has ultimate authority over the perpetual inventory records and inventory orders, she pays bills, handles payroll, takes deposits to the bank, and reconciles bank statements. She could easily steal from her business if she wanted to because she does not separate her powers, nor does she have anyone check all of the bank reconciliations that she deposits herself. Although Lucy prepares the bank deposits, Kayla could make new ones and deposit those without any approval or oversight from other employees. She also has overall control over the internal accounting system, so she could easily adjust the inventory, deposits, sales, returns, etc. in order for her to steal whatever she wants. As mentioned earlier, Kayla also has her own locked office in the back where she could hide the evidence of her theft and conspire to steal more.

CASE 5:

ANALYSIS OF INVENTORIES

1. Raw Materials Inventory:

    - Materials
    - Freight-in

    Work-in-Process Inventory:

    - Raw materials
    - Direct labor
    - Actual overhead costs

    Finished Goods Inventory:

    - Ending WIP
    - Raw materials
    - Direct labor
    - Actual overhead costs

2. Inventories are net of the estimated allowance for obsolete or unmarketable inventory.

3. a. Balance Sheet

    b. Gross inventory calculations:

2012	
Inventory	211,734
Estimated Allowance	12,520
Inventory, gross	**$224,254**

2011	
Inventory	233,070
Estimated Allowance	10,800
Inventory, gross	**$243,870**

c. Inventory allocation calculations:

2012			
Raw Materials:	$\frac{\$43,469}{211,734}$	= 0.2053	0.2053 x 12,520 =**$ 2,570.36**
Work in Process:	$\frac{\$619}{211,734}$	= 0.0029	0.0029 x 12,520 =**$ 36.60**
Finished Goods:	$\frac{\$167,646}{211,734}$	= 0.7918	0.7918 x 12,520 =**$ 9,913.04**

2011			
Raw Materials:	$\frac{\$46,976}{233,070}$	= 0.2016	0.2016 x 10,800 =**$ 2,176.77**
Work in Process:	$\frac{\$1,286}{233,070}$	= 0.0055	0.0055 x 10,800 =**$ 59.59**
Finished Goods:	$\frac{\$184,808}{233,070}$	= 0.7929	0.7929 x 10,800 =**$ 8,563.63**

4.

2012			
COGS		13,348	
	FG Inventory		13,348
Bad Debts		11,628	
	FG Inventory		11,628

5.

Journal Entries			
a.	COGS	572,549	
	FG Inventory		572,549
b.	FG Inventory	568,735	
	WIP Inventory		568,735
c.	WIP Inventory	442,068	
	RM Inventory		442,068
d.	RM Inventory	438,561	
	A/P		438,561
e.	A/P	432,197	
	Cash		432,197

T-charts for accounts:

RM Inventory

46,976	442,068
438,561	
$43,469	

COGS

0	
13,348	
572,549	
$585,897	

WIP Inventory

1,286	568,735
126,000	
442,068	
$619	

Accounts Payable

432,197	39,012
	438,561
	$45,376

FG Inventory, net

184,808	13,348
568,735	572,549
$167,646	

6. Inventory Turnover Ratio:

2012
$$\frac{585{,}897}{\left[\frac{(233{,}070 + 211{,}734)}{2}\right]} = \mathbf{2.634}$$

2011
$$\frac{575{,}226}{\left[\frac{(268{,}591 + 233{,}070)}{2}\right]} = \mathbf{2.293}$$

7. Inventory Holding Period:

2012
$$\frac{365}{2{,}634} = \mathbf{139\ days}$$

2011
$$\frac{365}{2{,}293} = \mathbf{159\ days}$$

The company is becoming more efficient in its inventory management because it is reducing its holding period, which means inventory is being sold at a faster rate.

8.

2012
$$\frac{13{,}348}{167{,}646} = \mathbf{7.96\%}$$

As an investor, additional information I might want from the company could include a Debt Ratio, Current Year Ratio, Acid Test, their average holding period from years prior to analyze exactly how much progress has been made, etc.

CASE 6:

CAPITALIZED COSTS AND EARNINGS QUALITY

WorldCom, Inc.

a) FASB Statement of Concepts defines the following as:

   i. *Assets:* probable future benefits that are obtained or controlled by an entity or company as a result of previous transactions.

   ii. *Expenses:* outflows or the use of assets from delivering or producing goods, providing services, or carrying out other activities.

b) When costs are capitalized, they are reported to appear as assets on the balance sheet. This causes the net income to appear higher than it should. It would be lower if the costs were shown as expenses.

c)

Line Cost (Expense)	14,739,000,000	
Cash		14,739,000,000

d) The costs that were improperly capitalized were the "line costs." WorldCom recorded communication and telecommunication costs as assets on their balance sheet rather than reporting them as expenses. They showed them to have future benefits by recording them as assets, but that is not the case. This does not meet the definition of an asset provided by FASB.

e)

Plant, Property, Equipment	3,055,000,000	
Line Cost (Expense)		3,055,000,000

f) Depreciation Expense calculation and journal entry:

Quarter 1:	$\frac{771,000,000}{22}$	x	$\frac{4}{4}$	**= 35,045,454.55**
Quarter 2:	$\frac{610,000,000}{22}$	x	$\frac{3}{4}$	**= 20,795,454.55**
Quarter 3:	$\frac{743,000,000}{22}$	x	$\frac{2}{4}$	**= 16,886,363.64**
Quarter 4:	$\frac{931,000,000}{22}$	x	$\frac{1}{4}$	**= 10,579,545.45**
				$83,306,818.19

Depreciation Expense	83,306,818	
Accumulated Depreciation		83,306,818

g) Net Income calculation, assuming line costs had not been improperly capitalized:

Income before taxes, as reported	$ 2,393,000,000
Add: Depreciation (f)	83,306,818
Less: Line costs	(3,055,000,000)
Loss before taxes, restated	(578,693,182)
Add: Income tax benefit (35%)	202,542,614
Add: Minority interest	35,000,000
Net Loss, restated	**($341,150,568)**

CASE 7:

LONG-TERM LIABILITIES

Targa Co.

In this case, Targa Company is planning to restructure a business line (Armor Track.) The company is going to consider relocating a manufacturing operation to a new facility, which will result in the termination of certain current employees. Targa prepares its statements in accordance with GAAP, so they need to follow the guidelines to account for the employee benefits as well as the relocation costs. My analysis of how this should be done follows:

RECOGNITION OF EMPLOYEE BENEFITS

The codification is pretty self-explanatory in its guidelines for recognizing employee benefits. In section 712-10-25-2, the codification states that any termination benefits should be recognized as a liability and a loss. It further states that the "cost of termination benefits recognized…shall include the amount of any lump-sum payments and the present value of any expected future payments." So, in this specific case, the cost of the termination benefits will include the $500,000 for two weeks' severance and the facility manager's lump sum of $50,000. They will also receive 10 weeks' pay.

RECOGNITION OF RESTRAINING AND RELOCATION COSTS

In section 420 of the codification, it discusses the costs associated with exit activity, which includes restructuring. In 420-10-05-2, it states that the costs include the involuntary employee termination benefits as well as the costs to close and relocate. In Targa's case, these costs will include the $500,000 relocation cost. Because the company has entered into irrevocable contracts concerning the restructuring, the company will recognize these costs as a liability.

CASE 8:

SHAREHOLDER'S EQUITY

Merck Co.

a.

i. Merck is authorized to use 5,400,000,000 shares.

ii. Merck actually issued 2,983,508, 675 shares at December 31, 2007.

iii. 2,983,508,675 issued shares at 1 cent per share bring the common stock dollar value to $29,835,086.75.

iv. 811,005,791 shares are held in treasury at December 31, 2007.

v. 2,172,502,884 shares are outstanding at December 31, 2007 (issued less treasury).

vi. 2,172,502,884 shares outstanding * $57.61 per share = $125,157,891,100 is the total market capitalization.

b. Companies pay dividends on their common or ordinary shares to show investors strength in their company and that they are growing. Not paying dividends could signify a lack of growth. Typically, when dividends are paid, this causes the company's share price to go down.

c. In general, companies repurchase their own shares because the stock is undervalued. The company can then repurchase it at a low price and resell it higher. They could also repurchase them to increase EPS, to provide stock for employee stock compensation plans, or to provide a tax efficient distribution to shareholders.

d.

Retained Earnings	3,310,700,000	
Dividends Payable		3,400,000
Cash		3,307,300,000

e.

i. Merck uses the cost method to account for its treasury stock transactions.

ii. Merck repurchased 26,500,000 shares on the open market in 2007.

iii. In total, Merck paid $1,429,700,000 in total and $53.95 per share to buy back its stock during 2007.

iv. Merck doesn't disclose its treasury stock as an asset because an asset is held for a future financial benefit. Treasury stock is a contra-equity account that cannot be recorded as an asset, even though one can gain cash from it.

f.

Merck ($)		
(in millions)	**2007**	**2006**
Dividends Paid	$3,307,300,000	$3,322,600,000
Shares Outstanding	2,172,502,884	2,167,785,445
Net Income	3,275,400,000	4,433,800,000
Total Assets	48,350,700,000	44,569,800,000
Operating Cash Flows	6,999,200,000	6,765,200,000
Year-end Stock Price	57.61	41.94
Dividends per Share	1.52	1.53
Dividend Yield	2.64%	3.65%
Dividend Payout	101.08%	74.94%
Dividends to Total Assets	6.84%	7.45%
Dividends to Operating Cash Flows	47.25%	49.11%

CASE 9:

STOCK OPTIONS

Xilinx, Inc.

a. In this case, Xilinx has a stock-based incentive plan that allows employees to purchase a specific number of shares in the company at a set price over a given period of time. These plans offer incentives of allowing employees to defer the taxation on the shares bought with the option until they have been sold. The stock-based compensation plans are used to attract and retain employees and to provide them with proprietary interest in the company.

b. Restricted stock units (RSU) are grants valued in terms of company stock; however, company stock is not issued at the time the grant is given. The company distributes the shares or the cash equivalent only after the recipient of the unit satisfies the vesting requirement. Companies may offer RSUs along with stock option programs to employees in order to offer two different types of incentives, one being a long-term benefit and the other being beneficial short term.

c. ***Grant date:*** The day the stock options are given to employees.

   Exercise price: The exercise price is equal to the market price of Xilinx common stock (the closing trading price reported by the NASDAQ Global Select Market) on the grant date.

   Vesting period: The time that an employee must wait in order to be able to exercise the stock options.

   Expiration date: The day the contract for the stock options expires.

   Options/RSUs granted: Stock options that are granted to employees.

   Options exercised: Stock options that are actually put into effect.

   Options/RSUs forfeited or cancelled: Stock options that are expired so employees forfeit the right to exercise them, or that the employee cancels and decides not to exercise.

d. Under Xilinx's stock purchase plan, employees can obtain a 24-month purchase right to purchase company stock at the end of each six-month exercise period. The incentive for employees to purchase these stocks is that the purchase price is 85% of the lower of the fair market value at the beginning of the 24-month period or at the end of each six-month exercise period. This incentive differs from the company's stock-based compensation plans as the compensation plans are focused more on long-term benefits.

e. The company is required to measure the cost of all employee equity awards that are expected to be exercised based on the grant-date fair value and to record that cost as a compensation expense over the period during which the employee is required to perform service in exchange for the award. The company is also required to record compensation expense for the unvested portion of previously granted awards that remain outstanding at the date of adoption.

f. i. In 2013, Xilinx reports $77,862 thousand in total expense for stock-based compensation.

   ii. Xilinx includes this expense on the Income Statement among Cost of Revenues ($6,356), Research and Development ($37,937), and Selling, General and Administrative ($33,569).

   iii. The amount of the expense appears in the Cash from Operating Expenses section of the Statement of Cash Flows under "Stock Based Compensations." It is a positive cash inflow.

iv. The income tax effect is the amount that becomes an Income Tax Payable for the stock compensation expense. See below (numbers are approximated).

	Book Income	**Tax Income**	
Revenue	$ 100,000	$ 100,000	
	(77,862)	(0)	
	22,138	100,000	
Tax	(6,641)	(30,000)	→ write a check
	$ 15,497	**$ 70,000**	

Deferred Tax Asset	22,137	
Income Tax Payable		22,137

v.

COGS	6,356	
R&D Expense	37,937	
SG&A Expense	33,569	
APIC – Stock Options		77,862

Deferred Tax Asset	22,137	
Income Tax Payable		22,137

CASE 10:

REVENUE RECOGNITION

Bier Haus

The five-step revenue recognition process is outlined in the codification, section ASC 606-10-05-04. The steps are listed and defined as follows:

Step 1: Identify the contract(s) with a customer—A ***contract*** *is an agreement between two or more parties that creates enforceable rights and obligations. The guidance in this Topic applies to each contract that has been agreed upon with a customer and meets specified criteria. In some cases, this Topic requires an entity to combine contracts and account for them as one contract. This Topic also provides requirements for the accounting for contract modifications.*

Step 2: Identify the performance obligations in the contract—A contract includes promises to transfer goods or services to a customer. If those goods or services are distinct, the promises are ***performance obligations*** *and are accounted for separately. A good or service is distinct if the customer can benefit from the good or service on its own or together with other resources that are readily available to the customer and the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.*

Step 3: Determine the transaction price—The ***transaction price*** *is the amount of consideration in a contract to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. The transaction price can be a fixed amount of customer consideration, but it may sometimes include variable consideration or consideration in a form other than cash. The* *transaction price also is adjusted for the effects of the time value of money if the contract includes a significant financing component and for any consideration payable to the customer. If the consideration is variable, an entity estimates the amount of consideration to which it will be entitled in exchange for the promised goods or services. The estimated amount of variable consideration will be included in the transaction price only to the extent that it is* ***probable*** *that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.*

Step 4: Allocate the transaction price to the performance obligations in the contract—An entity typically allocates the transaction price to each performance obligation on the basis of the relative ***standalone selling prices*** *of each distinct good or service promised in the contract. If a standalone selling price is not observable, an entity estimates it. Sometimes, the transaction price includes a discount or a variable amount of consideration that relates entirely to a part of the contract. The requirements specify when an entity allocates the discount or variable consideration to one or more, but not all, performance obligations (or distinct goods or services) in the contract.*

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation—An entity recognizes revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer (which is when the *customer obtains control of that good or service). The amount of revenue recognized is the amount allocated to the satisfied performance obligation. A performance obligation may be satisfied at a point in time (typically for promises to transfer goods to a customer) or over time (typically for promises to transfer services to a customer). For performance obligations satisfied over time, an entity recognizes revenue over time by selecting an appropriate method for measuring the entity's progress toward complete satisfaction of that performance obligation.*

The codification section ASC 606-10-25-19 refers to distinct goods or services, which will apply to parts of the case that follows. This section is defined here:

A good or service that is promised to a customer is distinct if both of the following criteria are met:

a. *The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct).*

b. *The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the promise to transfer the good or service is distinct within the context of the contract).*

I have applied these steps to the following situations:

PART I

Week 1: A college student walks into the Bier Haus on campus and orders a large plastic cup of beer. The bartender takes the order and says it will cost $5. The student hands the bartender $5. The bartender then pours the beer into a large cup and hands it to the student. The student rushes off to ACCY 304.

Step 1: Identify contracts with the customer.

The student orders a cup of beer with an understood agreement that he will pay the bartender for it, initiating a contract between the two. When the bartender takes the order, the contract has been made.

Step 2: Identify performance obligations in the contract.

The bartender has an obligation to serve the student the cup of beer and the student has an obligation to pay $5.00 to the bartender.

Step 3: Determine the transaction price.

The transaction price is $5.00.

Step 4: Allocate transaction price to performance obligations.

The price to be allocated in this case is the $5 for the beer. That is the only transaction made and the entire value of the $5 is allocated as revenue for the beer.

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation.

The revenue is recognized when the bartender satisfies his obligation by handing the beer to the student and the $5 is received.

Journal Entry:

Cash	5.00	
Sales Revenue		5.00

PART II

Week 2: The same student goes into the Bier Haus and orders a large beer in an Ole Miss thermal beer mug as part of a "drink on campus" campaign. The student plans to use this mug daily for refills rather than using plastic cups. The bartender pours the beer into the mug and delivers it to the student. The bartender then collects $7 from the student. Standalone selling prices are $5 for the beer and $3 for the mug, so the student got a bargain on the combined purchase. The student takes the beer in the new mug and enjoys it while reading the codification.

Step 1: Identify contracts with the customer.

The contract is made when the student orders the beer in the mug and the bartender takes the order.

Step 2: Identify performance obligations in the contract.

The bartender has an obligation to fulfill the student's order by filling the mug with beer and giving it to the student. The student has an obligation to pay for the mug of beer.

Step 3: Determine the transaction price.

The transaction price is $7.00 as that is what the student pays the bartender for the mug and beer combined.

Step 4: Allocate transaction price to performance obligations.

In this case, the price is allocated to the mug and the beer separately, as they each have their own standalone prices. This comes from section ASC 606-10-25-19 that was explained above. $4.375 is allocated to the beer and $2.625 is allocated to the Ole Miss mug. The calculations for these are as follows: The standalone price for the beer was $5 and the standalone price for the mug was $3, making a total of $8 value for both, however the student only paid $7. ($5/$8)*$7 = $4.375. This allocates the price of the beer alone. ($3/$8)*$7 = $2.625 allocated for the mug alone.

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation.

In this situation, revenue should be recognized when the bartender hands the student the mug of beer and the student hands over $7.

Journal Entry:

Cash	7.00	
Sales Revenue – Beer		4.375
Sales Revenue – Mug		2.625

PART III

Week 3: The same student goes into the Bier Haus bringing in his beer mug and orders a large beer and a pretzel. Standalone selling prices are $5 for the beer and $2 for the pretzel. The bartender tells the student they are out of pretzels. The bartender then offers the student the large beer and a coupon for two pretzels (its typical business practice) for $7. The student pays the $7 to the bartender. The bartender gives the student a coupon for two pretzels. The bartender pours the beer into the beer mug and hands it to the student. The student then takes the beer and the coupon and heads to the dorm to study for the upcoming Intermediate accounting exam. The Bier Haus sells a coupon for two pretzels for $3.50. To increase visits, these coupons can be redeemed at any date after the date of purchase. The Bier Haus has limited experience with these coupons but, so far, these coupons have always been redeemed.

Step 1: Identify contracts with the customer.

In this case, the student makes an order and the bartender tells the student they are out of pretzels, but offers him a large beer and a coupon instead. A contract is made when the student accepts the offer and the bartender takes that order.

Step 2: Identify performance obligations in the contract.

The bartender has an obligation to give the student a large beer along with a coupon for two pretzels. The student has an obligation to pay for the beer and coupon.

Step 3: Determine the transaction price.

The transaction price is $7, as that is the amount the student paid the bartender for the beer and coupon.

Step 4: Allocate transaction price to performance obligations.

For this situation, the price has to be allocated to the sales revenue that was earned by the sale of the beer and also for the unearned revenue of the coupon for the pretzels. $4.12 is allocated to the sale of beer and $2.88 is allocated to the coupon. The calculations are as follows:

The beer still had a standalone price of $5 and the coupon had a standalone price of $3.50, making the overall value of both $8.50 and the student only paid $7. To allocate the price of the beer: ($5 / $8.50) * $7 = $4.12. To allocate the price of the unearned revenue from the coupon: ($3.50 / $8.50) * $7 = $2.88.

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation.

The revenue in this situation should be recognized when the bartender gives the student the large beer and the coupon and the student hands him the $7.

Journal Entry:

Cash	7.00	
Sales Revenue – Beer		4.12
Unearned Revenue – Coupon		2.88

PART IV

Week 4: The same student goes into the Bier Haus and orders two pretzels. The bartender takes the order and asks for a $4 payment. The student hands the bartender the coupon. The bartender reviews the coupon, determines its validity, and accepts it as payment. The bartender gives the student the two pretzels. The student then heads off to share the pretzels with a classmate from ACCY 420.

Step 1: Identify contracts with the customer.

The contract is made when the student orders two pretzels and the bartender takes the order.

Step 2: Identify performance obligations in the contract.

The bartender has an obligation to validate the coupons received and fulfill the student's order by giving him the pretzels. The student has an obligation to give the bartender the coupon in order to receive the pretzels.

Step 3: Determine the transaction price.

The transaction price is the coupon, which is valued at $3.50. This has already been accounted at the allocated price of $2.88.

Step 4: Allocate transaction price to performance obligations.

The price has been allocated in Part III.

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation.

Revenue is recognized when the bartender accepts the coupon as payment and gives the student the two pretzels.

Journal Entry:

Unearned Revenue – Pretzel Coupon	2.88	
Sales Revenue – Pretzel Coupon		2.88

CASE 11:

DEFERRED INCOME TAXES

ZAGG, Inc.

a. Book income refers to the income that is reported on the financial statements of the taxable entity. The book income is typically different than the taxable income.

b. Define the following:

    i. *Permanent tax differences:* refer to transactions that are typically recognized for financial reporting purposes but not for income tax purposes.

    ii. *Temporary tax differences:* refer to assets or liabilities that have a difference between the carrying amount in the balance sheet and its tax base.

    iii. *Statutory tax rate:* the legal rate. Income tax could have multiple statutory rates for different income levels, and a sales tax could have a flat statutory rate.

    iv. *Effective tax rate:* the average rate at which a corporation or an individual is taxed. For an individual, it is the average rate that their earned income is taxed, whereas for a corporation it is the average rate at which its profits are taxed.

c. A company reports deferred income taxes as part of their total income tax expense rather than reporting their tax bill because they want their overall taxable income to be lower.

d. A deferred income tax asset is referred to as an asset on the balance sheet that can be used to reduce taxable income. Its opposite is a deferred income tax liability, which can increase income tax. It is also found on the balance sheet.

e. A business should create a valuation allowance for a deferred tax asset if there is more than 50% probability that the company will not realize some portion of the asset. Any changes that are made to the allowance should be recorded within "income from continuing operations" on the income statement.

f.

i.

Income Tax Expense	9,393	
Net Deferred Tax Asset	8,293	
Income Tax Payable		17,686

ii.

Income Tax Expense	9,393	
Deferred Tax Asset	8,002	
Deferred Tax Liability	291	
Income Tax Payable		17,686

iii.

$$\frac{\text{Tax Expense}}{\text{Pre-Tax Income}} = \text{Effective Tax Rate}$$

$$\frac{9{,}393}{23{,}898} = 39.3\%$$

iv. 6,956 + 6,912 → the $6,912 is found on the balance sheet as "deferred income tax assets" under current assets and $6,596 is found under just "deferred income tax assets."

CASE 12:

LEASES

Build-A-Bear Workshop, Inc.

a. Companies tend to lease assets rather than buy them because by leasing them, you get access to the asset immediately without having to pay the amount in full up front. You can pay back on a timely basis, which in turn will ease the company's cash flow. There are also various tax benefits that come along with leasing assets.

b. Define the following:

    i. *Capital lease:* a lease where the lessor only finances the leased asset, and all other rights of ownership transfer to the lessee. The criteria for a capital lease can be any of the following: the ownership is transferred from the lessor to the lessee by the end of the period; bargain purchase option (lessee can buy the asset from the lessor at the end of the lease term for a lower-than-market price); the lease period encompasses at least 75% of the useful life of the asset (the lease must be noncancellable at the time); or the present value of the minimum lease payments required by the lease is at least 90% of the fair value of the asset at the inception of the lease.

    ii. *Operating lease:* the rental of an asset from a lessor, but not under terms that would classify it as a capital lease. The concept of an operating lease allows a business to keep from recording an asset on its balance sheet.

    iii. *Direct-financing lease:* an arrangement where the lessor acquires assets and leases them to its customers, with the intent of generating revenue from the resulting interest payments. The lessor recognizes the gross investment in the lease and the related amount of unearned income.

iv. *Sales-type lease:* classified as such by the lessor when the fair value of the leased asset at the start of the lease varies from its carrying amount, it involves real estate, and there is a transfer of ownership to the lessee by the end of the lease term.

c. Accountants distinguish between different types of leases to give a more concise and relevant view of a company's financial statements. The leases can represent different types of transactions so it is important to know what kind of transaction is occurring, especially since some of the leases have different accounting methods.

d. i. This lease will be treated as an operating lease, as it does not meet any of the criteria to be considered a capital lease, but is still the leasing of an asset.

ii.	Year 1:	Rent Expense	100,000	
		Cash		100,000
iii.	Year 1:	Rent Expense	100,000	
		Deferred Rent		100,000
	Year 2:	Rent Expense	100,000	
		Deferred Rent	25,000	
		Cash		125,000
	Year 3:	Rent Expense	100,000	
		Deferred Rent	25,000	
		Cash		125,000

Year 4:	Rent Expense	100,000	
	Deferred Rent	25,000	
	Cash		125,000
Year 5:	Rent Expense	100,000	
	Deferred Rent	25,000	
	Cash		125,000

e. i. According to Note 10, the total rent expense for operating leases in 2009 was $46.8 million. This includes the office and retail store base rent expense ($45.9 million) and the contingent rents ($0.9 million) for 2009.

ii. The rent expense value totaling $46.8 million looks to be included in the "Selling, general, and administrative" section of the Income Statement for 2009. There is not a separate "Rent expense" account, so we can assume it is included here.

f. i. Present value calculation:

Period	Payment	Present Value	PV of Payment
1	$ 50,651	0.9346	$ 47,337
2	47,107	0.8734	41,145
3	42,345	0.8163	34,566
4	35,469	0.7629	27,059
5	31,319	0.7130	22,330
6	25,229	0.6663	16,811
7	25,229	0.6227	15,711
8	25,229	0.5820	14,684
			$ 219,644

ii.	Plant, Property, Equipment	219,644	
	Lease Obligation		219,644
v.	Lease Obligation	35,276	
	Interest Expense	15,375	
	Cash		50,651
	Depreciation Expense	27,455	
	Accumulated Depreciation		27,455

g. Build-A-Bear's management has incentives to structure its leases as operating leases, because operating leases do not increase the company's liabilities. Because of this, the current ratio is not negatively affected, which improves its view to creditors.

h. Ratio calculations:

	Original	**Capitalized**
Current Ratio	1.66	1.68
Debt-to-Equity	0.73	1.84
Debt-to-Assets	0.13	0.47